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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941.

No. 328

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ALABAMA ASPHALTIC LIMESTONE COMPANY,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR RESPONDENT.

JAMES A. O'CALLAGHAN,
111 W. Washington St.,
Chicago,
Counsel for Respondent.

THE DUNTHORP-WARNER PRINTING COMPANY, 310 WEST JACKSON, CHICAGO

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ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT.

BRIEF FOR THE RESPONDENT.

This is an appeal by the Petitioner, the Commissioner of Internal Revenue, from a decision of the Circuit Court of Appeals for the Fifth Circuit, affirming a decision of the United States Board of Tax Appeals, in favor of the taxpayer, Alabama Asphaltic Limestone Company. Upon application of the Petitioner this Court granted a Writ of Certiorari (R. 159).

Opinions Below.

The opinion of the United States Board of Tax Appeals, promulgated February 14, 1940 (R. 33-54) is published in 41 BTA 324. The opinion of the Circuit Court of Appeals affirming the Board (R. 154-157) is reported in 119 F. (2d) 819.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered May 5, 1941 (R. 157). A Writ of Certiorari was granted by this Court on October 13, 1941 (R. 159). This Court has jurisdiction under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

Question Presented.

Where all of the assets of an insolvent corporation, were, in pursuance of a Plan of Reorganization, sold at bankruptcy sale to a reorganization committee which immediately transferred, in accordance with the Plan said assets to a newly organized corporation in exchange for all of the latter's stock, which stock was forthwith distributed to noteholders of the insolvent old corporation, who had from time to time advanced money for the notes of the old corporation on the agreement that at the maturity of the notes, stock of the old corporation would be issued to them in payment of the notes: Did this constitute a Reorganization within the meaning of Section 112 (i) (1) and under Section 112 (b) (3) or (4), or a tax-free controlled exchange under paragraph (5) of said Section of the Revenue Act of 1928, so as to give the new corporation the right to use the same cost or basis for depreciation and depletion as the cost or basis of the old corporation, in accordance with Sections 113 (a) (6) (7) or (8) of said Act?

Statutes Involved.

These will be found in the Appendix, *infra*.

Statement.

Note: For brevity and to distinguish the three corporations in this case, they will be designated herein by the same descriptive words as in the opinion of the Court be-

low, namely, the Respondent (taxpayer) Alabama Asphaltic Limestone Company will be called the "new" corporation; its predecessor, Alabama Rock Asphalt, Inc., the "old" corporation; and the old corporation's parent corporation, the Deep Water Coal & Iron Corporation will be known as the "parent" company.

The new corporation claimed depreciation and depletion deductions herein, based on the cost of its property to the old corporation, which basis was denied by the Commissioner, who claimed the proper basis to be the price bid in 1931 at a bankruptcy sale by a creditors' committee, which caused the property to be conveyed to the new corporation (R. 38-9).

The bankruptcy sale was in pursuance of a Plan of Reorganization (R. 35). All of the property of the old corporation, through the sale and the committee, was transferred to the new corporation, in exchange for all of the stock of the new corporation (R. 38, 155). This stock was forthwith distributed to the stockholders and creditors of the old corporation in accordance with the Reorganization Plan. Of these creditors, those receiving 95½% of the new stock were the holders of $733,000 face value of promissory notes of the old corporation, all maturing February 1, 1930 (R. 38, 156). These notes represented $733,000.00 of cash, furnished by the noteholders to the old corporation for working capital (R. 34). These notes were all held by persons, all of whom (excepting two subsequent purchasers of $60,000.00 of notes) were stockholders of the parent corporation (R. 34).

These notes were all issued on the express understanding and agreement between the old corporation and its noteholders, that they were not to be paid at maturity on February 1, 1930 (on which date they all fell due) but were at said maturity date, in pursuance of a Plan of Reorganization, to be exchanged for corporate stock, or other permanent securities of the old corporation (R. 34).

From the time of the organization of the old corporation, these noteholders had planned and agreed to recapitalize and reorganize the corporation in that manner (R. 35).

These notes were all issued to, and held by persons who were stockholders of the parent corporation, which latter, in turn, owned all of the stock of its subsidiary, the old corporation (R. 34-5). At the maturity of the notes, it was found that two of the noteholders had transferred their notes to two strangers, who refused to be bound by the agreement to take stock for the notes at maturity, and who demanded payment in cash for their notes (R. 35). For the purpose of putting through the reorganization plan and necessarily getting rid of these two objectors, and to assure a good title to the assets in the new corporation, the other noteholders caused an involuntary bankruptcy proceeding to be filed against the old corporation, in which proceeding, the sale in question occurred (R. 35). The price of $150,000.00 bid at the sale was an arbitrary sum selected with the approval of the Referee in Bankruptcy to limit his commission of 1% to a reasonable amount, and had nothing to do with the value of the assets (R. 78).

This was all done in accordance with the Reorganization Plan which was filed and approved by the Court (R. 37, 155-6). The old corporation's business was continued, and was not interrupted at any time by the bankruptcy, or the transfer of its property to the new corporation (R. 38, 156).

The President of the old corporation became successively the Receiver, the Trustee in Bankruptcy, and the President of the new corporation (R. 36, 155). The entire stock of the old corporation, being held and owned by the parent corporation, had been pledged by it as collateral on an $80,000.00 note of the old corporation, which note and stock were purchased at about the time of the bankruptcy by a noteholder, which regarded the stock as valueless, and

required no stock of the new corporation to be issued to it, but did receive stock of the new corporation in exchange for the note (R. 35, 147). Stock was also issued by the new corporation to the parent corporation as a noteholder (R. 147).

Minor creditors of the old corporation received about 4½% of the stock of the new corporation; the remaining 95½% of the stock of the new corporation went to all of the noteholders of the old corporation (including the $80,000.00 noteholder above mentioned, who then, by recent purchase, owned all of the stock of the old corporation) (R. 147, 38, 156). All of these noteholders who received new stock, had agreed to take stock for their notes in the old corporation (R. 34, 82). They also owned the old corporation through their being stockholders of the parent corporation, which in turn owned the old corporation (R. 34, 155). All of the stock-owners and creditors of the old corporation received all of the stock of the new corporation (R. 38, 156).

At the time of the reorganization January 1931, all of the stock of the old corporation was owned by A. Iselin & Co. (R. 81), a firm of bankers which was largely interested in the old corporation, and in its parent (R. 79). Iselin & Company came into possession of the stock of the old corporation in the following manner: Some money ($80,000.00) was borrowed by the old corporation from the National Bank of Commerce in New York City. The note was endorsed by the parent of the old corporation, and it was guaranteed by Iselin & Company. With that note the parent deposited as collateral all of the stock of the old corporation. The note was not paid, and the note and collateral were sold about January 29, 1930 to Iselin & Company at face value of the note (R. 79, 81). It was guarantor on the note (R. 79). The stockholders of the old corporation were first, the parent corporation and later, Iselin & Company, but at the time of the Reorgan-

ization, only Iselin & Company. Although it was not of record it owned the stock (83). The parent was the record owner (R. 36).

The total sum advanced (or invested) by the noteholders was $733,687.48 (R. 34). The opening balance sheet of the new corporation as of January 19, 1931 shows total assets of $613,364.91 subject to liabilities of $40,000.00 and a reserve for depreciation of $70,775.68. The fixed depletible assets are shown as $195,679.02, and the depreciable assets $342,935.45 of the total assets (R. 150).

ARGUMENT.

I.

ıe Noteholders of the Old Corporation Must Be Accepted as Stockholders Which Fact Nullifies the Basis of Petitioner's Argument.

We believe that the facts in our case as set forth in the tatement herein, clearly demonstrate that the creditors ıoteholders) of the old corporation must be considered having the *status* of stockholders. If so, our case is ffferent from the other associated cases to be argued fore this Court at this Term.

The Commissioner furnished us with a copy of his brief the *Southwest Consolidated Corporation*, a companion se with ours here. The Commissioner's brief in our se is a skeleton brief, and refers us to his brief in the *uthwest Consolidated* case.

The Commissioner proceeds, in our case, on the theory at our stockholders in the new corporation were merely editors of the old corporation, and that if we have any se at all, we are in the same position as are the bondlders and creditors in the *Southwest Consolidated* and e other associated cases referred to.

If the position of the Commissioner is correct that the ockholders of our new corporation were merely creditors the old, then most of what is argued by the Respondent the *Southwest Consolidated* is applicable to our case.

But our case is a different one from the others. Our ockholders in the new corporation were more than credirs of the old because they advanced money from time to ne to the old corporation for the construction of its

plant, etc., on the agreement that they would receive stock in the old for their advancements, on or about February 1, 1930. They were given notes for their advancements. They were, to all intents and purposes, stockholders of the old corporation. The Board and the Circuit Court so regarded them. The Board in its Finding of Fact 4, at page 34 of the Record said:

> "These loans or advances were made by the stockholders of the Deep Water Corporation upon the express understanding that they would receive stock or securities of the old corporation for the respective amounts so advanced."

The Circuit Court at page 155 of the Record said (referring to the Board's Findings):

> "Of the facts there found, the most important are that the old corporation was a wholly owned subsidiary of Deep Water Coal and Iron Corporation, organized in 1927, by the parent company deeding to its subsidiary, mineral properties which cost the parent $208,901.00, for the entire capital stock. The subsidiary had no working capital and it borrowed some money on the endorsement of the parent company, secured by pledge of the subsidiary's capital stock, but that not being enough the parent company's stockholders furnished $733,687.00, on 7% notes due February 1, 1930 but on an understanding among them all that the notes would be funded into stock or other permanent securities of the subsidiary."

In his argument in the *Southwest Consolidated* case, the Commissioner attempts to reverse the situation in the decision of *Le Tulle* v. *Scofield*, 308 U. S. 415, by urging the same argument that the Court below in our case refused to follow (R. 156), namely, that if the stock of a new corporation in a typical reorganization goes to the creditors of the old insolvent corporation instead of going to its stockholders, then there is not a statutory reorganization.

This argument of the Commissioner, which he urged in

our case below, and he urges in the *Southwest* and other cases here, falls to the ground in our case, because our noteholders must be accepted as stockholders. This is especially true in our case when it is remembered that new corporation stock in our case was also issued to the owners of the stock of the old corporation. We contend, of course, that the Commissioner's argument is unsound even if our noteholders be regarded only as creditors.

That the noteholders in our case should be regarded in the light of shareholders or stockholders of the old corporation is demonstrated by the uncontradicted evidence, the findings of the Board, and the decision of the Court below. These are set forth with page references to the record in our Statement, and will not be repeated here. At the hearing before the Board the Commissioner did not attempt to contradict the facts as found or to introduce any other evidence. The form of the written and verbal proof that the noteholders had agreed to take stock, is not material. It is the actual facts that count. Substance, not form, controls, especially in tax cases. *First Seattle Dexter Bank*, 77 F. (2d) 45. Even the decisions of State Courts support our contention that these noteholders of the old corporation should be regarded as stockholders:

In *Laurson* v. *Memering*, 260 Ill. App. 515 (1931) where the complainant paid a corporation for his stock, which was not delivered, and later the corporation tendered the stock on conditions to which the complainant refused to agree, the Court says (p. 524) that in determining whether or not the transaction was a sale, or an agreement to sell, the facts of the whole transaction must be considered, and that it is not necessary that the agreement be in writing; that it is sufficient, if it can be seen that it was a sale or offer to sell which was so far consummated that the purchaser had paid his money. In our case the noteholders had paid their money in advance for the old corporation's stock, and took

as receipts, notes which they understood would not be paid at maturity.

In *Gibson* v. *Oswalt* (Mich. 1934) 257 N. W. 825, it was held that stockholders who refused to attend a meeting to consider a plan of consolidation of two banks were estopped to deny their statutory liability as owners of stock, the Court saying that subscriptions to corporate stock need not be in any stated form "but may even be deducible from the acts and conduct of a party" (cases cited). The Court further says that a certificate of stock is merely evidence of the ownership of shares; that its possession or issue is not necessary to constitute one a stockholder, and that one may be a stockholder, even if not so recorded on the books of the corporation (cases cited).

In *Rutenbeck* v. *Hohn* (Ia.) 121 N. W. 698, it was held that subscriptions to corporate stock could be made by oral agreement, even though the word "subscribed" involves the idea of a written signature.

In *Gailbraith* v. *McDonald* (Minn.) 143 N. W. 353, where defendant was sued on a note he gave to a corporation for stock, but the stock was not delivered and the corporation became bankrupt, the Court holds that the transaction was a subscription to the stock, and that any agreement by which a person shows an intention to become a shareholder is sufficient to constitute a contract of subscription and that it was not necessary that a certificate for the stock be issued.

Similarly, in the case at bar, the stockholders of the parent corporation who furnished the old insolvent corporation with its capital and received its notes therefor, understood that these notes were not issued as promises to pay money and were not to be paid at maturity. They knew as a fact that the notes could not be paid at maturity, because they all fell due on one day. The monies advanced had been invested in land, buildings and other fixed assets

(Tr. 34). The notes were like informal receipts for money paid in advance for stock or for other permanent securities, to be issued to the noteholders for the notes in a reorganization which was to take place at the maturity of the notes around February 1, 1930.

Further, it will be remembered that the noteholders were all stockholders in the parent corporation, which in turn owned all the stock of the old corporation. In substance, these noteholders were the real parties in interest through the ownership by the parent of its subsidiary, the old corporation. It is obvious that these special facts and circumstances in our case differentiate it from its companion cases at bar, and classify the noteholders in our case not only as creditors entitled to take, own, and control all of the assets of the insolvent corporation, but also as being in the position of stockholders.

II.

The Case of Le Tulle v. Scofield Is Not Applicable Here.

In the *Southwest Consolidated Corporation* brief, the Commissioner relies upon the case of *Le Tulle* v. *Scofield*, 308 U. S. 415, and its accompanying case, *Helvering* v. *Tyng*, 308 U. S. 527, the facts in which are entirely different from the facts in our case; and in his attempt to make the *Le Tulle* case applicable, the Commissioner switches the principles of that case from those applying to a *solvent* assignee to make them apply to an *insolvent* assignor as in our case.

In the *Le Tulle* case, the seller received from the purchaser the latter's cash and bonds, but no stock. It was there held that the seller did not retain any proprietary interest in the purchasing corporation; that there was a sale, and not a reorganization. Furthermore, in the *Le*

Tulle case, the purchaser was *solvent*, its corporate shareholders held stock which was not worthless, and there was no showing or contention in that case that either the seller or purchaser was insolvent, as was the transferor in our case. The point did not arise and was not considered in the *Le Tulle* case whether the bonds received would have been a proprietary interest, if the purchaser corporation had been insolvent, its stock worthless and if the bondholders had become the owners and controllers of the corporate enterprise.

The Commissioner in his argument assumes that a bondholder, or other creditor, after default, or otherwise, can never change his status under any circumstances, from that of a creditor, to one having a proprietary interest or stake in the enterprise, or in its assets.

Our views of the holding in the *Le Tulle* case are not ours alone. They are the holdings of the Circuit Court of Appeals, in *Commissioner* v. *Cement Investors*, 122 F. (2d) 380 (C. C. A. 10, 1941); *Helvering* v. *New Haven R. R.*, 121 F. (2d) 985 (C. C. A. 2, 1941); the instant case in the Court below, 119 F. (2d) 819 (C. C. A. 5, 1941); *Commissioner* v. *Southwest Consolidated Corporation*, 119 F. (2d) 561 (C. C. A. 5, 1941). The Board also so held in *James Q. Newton Trust*, 42 B. T. A. 473; affirmed in 122 F. (2d) 416. There is also respectable authority from learned law commentators who reflect the generally accepted interpretation of the principles laid down in the *Le Tulle* case. Randolph Paul, the learned authority of a leading text-book on Federal taxation, states in his book, "*Studies in Federal Taxes, 3rd Series*", that the *Le Tulle* case merely decides that bondholders in a *solvent* corporation, since they are not equity proprietors, cannot be the conduit for the requisite continuity of interest and that the reasoning of the *Kitselman* case is supported by *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 109. To the same effect is the conclusion of the

learned editor of Commerce Clearing House *Standard Federal Tax Service*, in a very complete and well considered study, covering eighteen pages on the reorganization of corporations, through foreclosures, etc. found in Volume 1 of the 1940 C. C. H. Service, under "Illustrative Cases" beginning on page 63, at pages 75 and 77. An excellent commentary on the reorganization cases now pending before the Court at this term will be found in the December, 1941, issue of the Harvard Law Review, Vol. LV, No. 2, page 292.

In his Brief in the *Southwest Consolidated Corporation* case the Commissioner in his argument on the *Le Tulle* case suggests that "the legal questions should be considered against the background of the practical tax aspects of the problem". This amounts to the argument that his construction of the law should be accepted so that he can collect more taxes. But what of the correlative obligations of the Government and the Commissioner toward the taxpayer? The holders of millions of dollars of bonds of numerous insolvent corporations have been denied losses by the Commissioner in reorganizations like those involved in the cases at bar, upon the contentions of the Commissioner that the exchange of stocks of the new corporation for bonds of the old corporation, was actually a tax-free reorganization, and that therefore the bondholders did not sustain any loss by the exchange. The Commissioner so contended in the *Kitselman* case (C. C. A. 7) 89 F. (2d) 458, Cert. Den. 302 U. S. 709; in the *Burnham* case 33 B. T. A. 147, affirmed 86 F. (2d) 776, Cert. Den. 300 U. S. 683; in the *Rockford Brick & Tile Co.* case, 31 B. T. A. 537.

After the statute of limitations has barred all of such bondholders' rights to claim such losses, the Commissioner now seeks to shift his former position, which was that these cases were statutory reorganizations, which is only what the taxpayers are now claiming in the cases at bar. He

now wants to reverse his position, not so much, on that point, as on the practical argument that he can collect more taxes that way.

In the *Kitselman* case for example, in his brief before the Circuit Court of Appeals the Commissioner argues as follows, pages 17, 18 and 23:

> "Under these decisions, it is submitted, for reorganization purposes, a bondholder stands in no different position from a stockholder with respect to an interest in the assets and affairs of a corporation, and where, as in the present case, the bondholders were the only parties in interest in the assets of an insolvent corporation, a continuity of their (the bondholders) interest in the assets in the hands of a new corporation is a sufficient compliance with the requirements of the statute. That these bondholders were the only real parties in interest will be realized when it is observed that upon the foreclosure sale all the properties of the old corporation brought only '$430,000 free and clear of all liens and encumbrances, except the lien of any taxes, assessments, and water rents lawfully levied or assessed, and also the lien of the first mortgage securing the I. Ry. Co. bonds not in default' (R. 32-33) and that the defaulting bond issues under which these assets were sold amounted to the total sum of $3,989,000 (R. 31)."
>
> . . . . . .
>
> "It is also plain, we submit, that merely because one of the steps in the plan of reorganization as formulated and executed consisted of foreclosure proceedings and a judicial sale of the mortgaged assets prior to transfer to a new corporation formed for that purpose, such procedure will not defeat what may otherwise be regarded as a statutory reorganization. It will also be observed that this procedure was taken 'at the instigation of the committee, in pursuance of the plan and agreement' (R. 32). It has long been established that acquisition of assets through the medium of foreclosure proceedings does not of itself take the transfer out of reorganization provisions. *De Blois* v. *Commissioner*, 36 F. (2d) 11 (C. C. A. 1st); *C. H. Mead Coal*

Co. v. *Commissioner*, 72 F. (2d) 22 (C. C. A. 4th); *Securities Co.* v. *Commissioner*, 64 F. (2d) 330 (C. C. A. 2nd); *Shoenberg* v. *Commissioner*, 77 F. (2d) 446 (C. C. A. 8th). See also, *First National Bank of Champlain, N. Y.* v. *Commissioner*, 21 B. T. A. 415; *Rockford Dairy, Inc.* v. *Commissioner*, 26 B. T. A. 501."

* * * * *

"It is plain, we submit, in the present case that the foreclosure proceedings, the purchase of the assets of the old corporation by the bondholders' committee, and the transfer of the assets to a new corporation formed for that specific purpose, in exchange for stock and bonds of the new corporation, were all steps in a single plan of reorganization of the old corporation. It has long been established, in the application of the pertinent reorganization provisions, that the component steps of what may be regarded as a single or general plan looking to the reorganization of a corporation will not be treated separately."

In the same *Kitselman* case, the Government Brief filed in the Supreme Court, opposing the taxpayer's Petition for Certiorari, at pages 12 and 13, sets forth the following:

"Petitioner contends that there was no reorganization since neither the old C. S. B. & N. I. Ry. Company, nor its stockholders, acquired any interest in Northern Indiana Railways, Inc. We submit that where the corporation's liabilities greatly exceeded its assets, so that only bondholders participated in the reorganization, it is sufficient that the bondholders received a substantial interest in the new corporation in the form of common stocks and bonds. The only reason the stockholders did not participate in the plan was that their stock represented no assets and was valueless, and therefore they were without right to speak. See *In re 620 Church St. Corp.*, 299 U. S. 24, 27. While bondholders are ordinarily viewed merely as creditors, when the assets of the corporation in receivership are less than its obligations, the bondholders are for all practical purposes the corporation. All that remains for the stockholders is the corporate charter. Here it

is clear that the bondholders were the moving spirit in the reorganization and acted throughout as the owners in fact of the corporation's assets. The decision of the Court below gives practical and common sense recognition to a well-defined type of business reorganization."

This brief also stated at page 15:

"It has long been recognized that the acquisition of assets through the medium of foreclosure proceedings does not of itself take the transfer out of the reorganization provisions. *De Blois* v. *Commissioner*, 36 F. (2d) 11; *C. H. Mead Coal Co.* v. *Commissioner*, 72 F. (2d) 22."

Furthermore, as early as 1924, the Commissioner embodied these principles in a ruling in I. T. 2071, III-2 C. B. 34, where he, in referring to the comparable provisions of the 1918 and 1921 Acts, stated,

"The most common form of reorganization, especially in the case of defaulting corporations, is a reorganization in connection with an execution or foreclosure sale. It is often advisable for the bondholders of such corporation to formulate some scheme of reorganization and in order to consummate the reorganization they may enter into an agreement for this purpose, appoint a committee or other agent to represent them, to purchase the property at a foreclosure sale for their benefit, to form a new corporation and to transfer the property to it in return for stock or bonds or both. In the case of foreclosure, the reorganization takes place by procuring a sale under the mortgage, purchasing the property at the sale, and causing the same to be transferred to another corporation organized for that purpose by the bondholders. When the reorganization is through a foreclosure sale, stockholders need not be joined in the plan nor given the right to participate, and if they are given the right to participate it is purely a matter of favor."

The Commissioner appears to believe that the foregoing prinicples should operate in his favor whenever it suits his

purpose to urge them, overlooking the fact that they are rules of general application which apply, whether the results are favorable to him or to the taxpayer.

III.

The Reorganization in Our Case Was a Reorganization in Pursuance of Section 112 (b) of the 1928 Act, Under Paragraphs (3) or (4) of Said Section; Or Was a Tax-Free Controlled Exchange (Which Is Not Required to Be a Reorganization) Under Paragraph (5) of the Section.

The Commissioner in his brief in the *Southwest Consolidated* case, claims (and he claims the same in our case) that there was no reorganization and that he has a right to break the proceedings into steps, and to regard each step separately. He claims that the sale was a separate step, and that the price paid at the sale (or, under his new theory, the then value of the assets) is the controlling price and the basis to be used by the new corporation, instead of the cost or basis of the assets on the books of the old corporation. This assumes that the sale was not a part of a Plan of Reorganization. Yet in his petition for the Writ of Certiorari, in our case, the Commissioner states (page 2) under "Question Presented":

> "Pursuant to Plan, corporate assets were bought in by a creditor's committee at bankruptcy sale."

His brief in our case speaks of a "Plan". (P. 3) What plan? Why does the Commissioner omit the word "Reorganization" from "Plan"? It was not omitted from the Commissioner's brief filed in the Court below where on page 2, "Questions Presented", the Commissioner states:

> "The underlying question is whether the predecessor corporation, being insolvent, and its assets subject to sale in bankruptcy proceedings, for the benefit of creditors, the purchase and transfer of such assets, pursuant to a Plan of Reorganization, formulated and

executed by a majority of the creditors, involved the requisite continuity of a proprietary interest in the assets * * *."

Now, the Commissioner isolates one step—the sale—and chooses the $150,000.00 bid at the sale, instead of the basis of the old corporation on which the taxpayer had taken its depreciation and depletion. The fact is, as shown in our Statement, that this $150,000.00 figure was an arbitrary small amount selected with the approval of the Referee to limit his 1 per cent commission for services to a reasonable amount; and had nothing to do with the value of the assets. Further, in arguing that the single step, the sale, was the thing which fixed the cost of the assets, the Commissioner is forced to argue that there was no reorganization, that the findings of the Board of Tax Appeals that there was a reorganization and the affirming opinion of the Court below on that point, should be disregarded.

That similarly, must be disregarded all findings of the tribunals below, the documentary evidence, and the uncontradicted testimony in the case which show conclusively that from the very inception of the old corporation a reorganization had been planned. The sale itself was only one step in a series of steps in a completely planned reorganization set up months before the petition in bankruptcy was filed.

His argument forces the Commissioner to take another untenable position, namely, that the committee bought these assets for *itself*, ignoring the noteholders. In arguing that the committee was the purchaser and owner of the assets, and that its bid price at the sale governs, and that the transfer by the committee to the new corporation was an independent transaction or sale, the Commissioner overlooks the entire Plan of Reorganization (approved by the Court) covering a series of interdependent steps formulated to accomplish the final result of transferring the assets of the old corporation to the new, in exchange for

all of the latter's stock. The committee acquired them for that purpose under order of Court.

In passing, we may dispose of a point which the Commissioner argues at page 21 of his *Southwest Consolidated Corporation* brief. It does not apply in our case. He states in that brief that clause B of Section 112 (g) (1), is not applicable since it requires that the acquisition by the transferee corporation shall be *solely* in exchange for voting stock, but that cash for dissenters was also paid. The section of the law he there quoted is the 1934 Act which may be applicable in the *Southwest* case. It is not applicable to our case because our reorganization was in 1931 and therefore the 1928 law applies. The 1928 law was different. The 1934 law, Section 112 (g) (1), the relevant part of which is as follows:

> "The term 'reorganization' means (A) a statutory merger or consolidation or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock, of at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, * * *."

The corresponding section of the 1928 law is Section 112 (i) (1) the relevant part of which, reads:

> "The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation or substantially all the properties of another corporation), * * *."

The 1934 law requires the issuing (new) corporation to issue *solely* voting stock for the properties of another corporation. The 1928 law contains no such requirement.

Further, in our case, the cash used by the creditors' committee was advanced by A. Iselin & Co. to the com-

mittee during the reorganization. Its repayment was assumed by the new corporation. If this be deemed an assumption of indebtedness of the old corporation, it does not affect the reorganization. The Act of June 29, 1939 which added paragraph (k) to Section 112, provides that where one party to a reorganization assumes a liability of another party, such liability shall be disregarded and not considered as money paid, and shall not affect the reorganization; and these provisions were also made retroactive through all the Revenue Acts back to the Revenue Act of 1924. Neither the Board nor the Court below found that the small amount of cash paid for expenses and to the two dissenters in our case affected the reorganization.

The facts in our case make it a reorganization as defined in paragraph (3) or (4) of Section 112 (b) or make it a tax-free controlled exchange as defined in paragraph (5) of that section of the Revenue Act of 1928. It falls under these definitions by being a merger or consolidation, or the acquisition by the new corporation of substantially all the properties of the old corporation. It may also qualify thereunder by being the acquisition by the old corporation (in effect through its representatives) of at least a majority of all of the stock of the new corporation. It may also qualify under the definition in paragraph (B), as being a transfer by the old corporation of all of its assets to the new corporation, because immediately after the transfer, the transferor (through its representatives, its noteholders) who were deemed to be stockholders, were in control of the new corporation.

We shall presently consider paragraphs (3) and (4). Let us first show that our transaction was a tax-free controlled exchange under paragraph (5) of Section 112 (b): Paragraph (5) does not require a transaction to be a reorganization at all, or to come under any of the definitions of a reorganization. Paragraph (5) requires only that property be transferred to a corporation by one or more

persons (here the old corporation or the noteholders through their committee), in exchange for stock or securities of the new corporation and immediately after the exchange such person or persons are in control of the corporation, (but in the case of two or more persons, the amount of securities or stock received by each must be substantially in proportion to his interest in the property prior to the exchange). That fits our case. In addition, if the notes held by the noteholders be considered as having been exchanged for the stock of the new corporation, then the notes, whatever their character as debts or claims, would qualify as "property", which was transferred to the new corporation, by one or more persons, in exchange for stock of the new corporation, and it was substantially in proportion to their interest in the property prior to the exchange. Many cases sustain our position:

In *Rockford Brick & Tile Co.* 31 B. T. A. 537, the Commissioner argued there was a tax-free exchange under paragraph (5) of Section 112 (B). He was successful and was upheld by the Board. In that case the facts were that *unsecured open accounts* of the old corporation were exchanged, through a creditor's committee, for stock of the new corporation and the creditors were in control of the new corporation after the exchange.

Similarly in the *Leckie case*, 37 B. T. A. 252, the Commissioner was successful in claiming the transaction to be a tax-free exchange under paragraph (5) where a creditor's committee, representing bondholders, bought the assets at foreclosure sale, and transferred the assets to a new corporation, and the bondholders received the stock and were in control of the new corporation.

We have already stated, and cited authorities to show that in tax cases the court looks at the substance, and not the form, of the transaction. This Court has held that where there is doubt, tax-laws are to be construed most

favorably to the taxpayer. *White* v. *Aronson* 302 U. S. 16; *Gould* v. *Gould*, 245 U. S. 151.

Coming now to paragraphs (3) and (4) of Section 112 (b), the decisions of the Board and of the Court below, in our favor, leave no doubt that our transaction was a reorganization under paragraphs (3) or (4). In view of the fact that the supporting decisions will probably be discussed thoroughly in the several briefs in the associated cases at bar, and in the oral arguments, we shall review only a few of them here.

In *Commissioner* v. *Kitselman*, 89 F. (2d) 458 (Cert. Den. 302 U. S. 709), the Commissioner urged that the transaction was a reorganization, in order to prevent a taxpayer from being allowed a loss on his defaulted mortgage bonds. The old corporation was insolvent. The Court found that the stock was valueless and that the stockholders for that reason did not participate in the new corporate stock. The Court also held that the bondholders in an insolvent corporation stepped into the place of the stockholders and superseded them. In that case there was a foreclosure by a bondholders' depositary committee, which, after purchasing the property, conveyed it to a new corporation in exchange for its securities, which were issued to the *bondholders* of the old corporation.

In the *Leckie case*, 37 B. T. A. 252, a bondholder's committee bought at foreclosure sale, real estate securing the bonds, and then transferred the property to a new corporation, in exchange for its stock. The *bondholders* and not the stockholders of the old corporation received the stock of the new corporation. The Commissioner urged, and the Board held that whether or not there was a reorganization under paragraph (3), there was at any rate a tax-free exchange, which did not have to be a reorganization, under paragraph (5) of Section 112 (b) because there was a transfer of property (bonds) to the new corporation for

its stock, and immediately thereafter, the bondholders were in control of the new corporation.

In *Burnham* v. *Commissioner*, 33 B. T. A. 147, affirmed by the Circuit Court of Appeals, in 86 F. (2d) 776 (Cert. Den. 300 U. S. 683), the Commissioner again in order to prevent a noteholder from being allowed a loss, contended and was successful in having the Board and the Court hold, that the transaction was a reorganization under paragraph (3) of Section 112 (b) of the 1928 Act. In this case, unsecured promissory notes due on or before ten years after date were exchanged for stock of a new corporation under a Plan of Reorganization. The Commissioner's contention that the notes were securities and that the issuance of the new corporation stock to the noteholders of the old corporation was a reorganization, were upheld by the Board and the Court.

In *Newberry Lumber & Chemical Co.* v. *Commissioner*, 94 F. (2d) 447, the old corporation being insolvent, defaulted on its mortgage bonds. A bondholders' committee purchased the assets at public sale, and paid for the mortgaged assets with the bonds, plus sufficient *cash* to pay the non-depositing bondholders and the expenses of the sale. (The facts on this point were like those in our case.) The Committee formed a new corporation to which it conveyed the assets in exchange for the stock and bonds of the new corporation. These new securities were distributed among the bondholders of the old corporation. The Commissioner claimed and the Board sustained him, that the basis of the new assets should have been the cost price paid by the committee at the Master's sale. The Appellate Court overruled this and held there was a reorganization under paragraphs (3), (4) and (5) of Section 112 (b) of the 1928 Act and that the new corporation could use as its basis the cost of the assets to the old corporation.

The *Newberry* case was followed in the case of *Mark Kleeden* v. *Commissioner*, 38 B. T. A. 821, in which stock-

holders of three corporations voted to transfer their assets to one man, who transferred them to a new corporation in exchange for its stock, which was delivered to the old corporation. The Commissioner claimed that the transaction should be divided into steps, but the Board overruled him and held it was a non-taxable reorganization. The Commissioner acquiesced in the decision of the Board (see 1939—1 C. B. 20).

In *Thurber* v. *Commissioner*, 84 F. (2d) 815, where after a reorganization plan had been approved by the stockholders of two corporations, it was changed and was still held to be a reorganization; the Court overruled the Board by holding that the Board had erroneously picked out a single step of a transaction which involved a series of steps, and had held that this step constituted a sale. The Court held that the transaction should have been viewed as a whole, and not as a transaction consisting of single steps.

In the *La Arcada* case, 35 B. T. A. 80, the Board held and cited decisions holding that the bid price at a public sale is not conclusive of the cost of depreciable property acquired in foreclosure or comparable circumstances.

In closing we call the Court's attention to the statement of the Government in its brief in the *Southwest Consolidated* case, at page 12:

> "Where a corporate transaction results in a continuation of an existing investment merely in a different form, it is understandable that the owners of that investment should be permitted to retain the same basis for tax purposes. Regulations 86, Article 112 (g)-1. (Appendix, *infra*.) That basis continues to reflect the investment cost of the properties still indirectly owned by the same persons."

That statement covers our case. The original investment of our noteholders in the old corporation was continued in a different form in the new corporation.

Conclusion.

We believe that the decision of the Circuit Court of Appeals affirming the decision of the Board should be affirmed.

Respectfully submitted,

JAMES A. O'CALLAGHAN,
Counsel for Respondent.

JAMES A. O'CALLAGHAN,
111 W. Washington St.,
Chicago, Illinois.

December, 1941.

APPENDIX.

Revenue Act of 1928, c. 852, 45 Stat. 795:

Sec. 112. Recognition of Gain or Loss.

* * * * * *

(i) **Definition of reorganization.**—As used in this section and sections 113 and 115

(1) The term "reorganization" means (A) a merggr or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or its stockholders or both are in control of the corporation to which the assets are transferred, or (C) a recapitalization, or (D) a mere change in identity, form, or place of organization, however effected.

* * * * * *

(j) **Definition of Control.**—As used in this section the term "control" means the ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation.

* * * * * *

(b) (3) **Stock for stock on reorganization.**—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(b) (4) **Same—Gain of corporation.**—No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securi-

ties in another corporation a party to the reorganization.

(b) (5) **Transfer to corporation controlled by transferor.**—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange.

(Note: Sec. 112 (i) (1) The definition of reorganization, above, was amended by Sec. 213 of the Revenue Act of 1939 to the effect that the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability shall be disregarded. See IRC Sec. 112.)

Sec. 113. Basis for Determining Gain or Loss.

(a) (7) **Transfers to corporation where control of property remains in same persons.**—If the property was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control in such property of 80 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made. This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer;

(a) (8) **Same—Corporation controlled by transferor.**—If the property was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described

in section 112 (b) (5) (including, also cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made;

Sec. 114. Basis for Depreciation and Depletion.

(a) **Basis for depreciation**—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in Section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property.—

(b) **Basis for depletion**—

(1) **General Rule**—The basis upon which depletion is to be allowed in respect of any property shall be the same as is provided in Section 113 for the purpose of determining the gain or loss upon the sale or other disposition of such property, except as provided in paragraphs (2) and (3) of this subsection.

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SUPREME COURT OF THE UNITED STATES.

No. 328.—October Term, 1941.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Alabama Asphaltic Limestone Company.

On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[February 2, 1942.]

Mr. Justice Douglas delivered the opinion of the Court.

Respondent in 1931 acquired all the assets of Alabama Rock Asphalt, Inc., pursuant to a reorganization plan consummated with the aid of the bankruptcy court. In computing its depreciation and depletion allowances for the year 1934, respondent treated its assets as having the same basis which they had in the hands of the old corporation. The Commissioner determined a deficiency, computed on the price paid at the bankruptcy sale.[1] The Board of Tax Appeals rejected the position of the Commissioner. 41 B. T. A. 324. The Circuit Court of Appeals affirmed. 119 F. 2d 819. We granted the petition for certiorari because of the conflict between that decision[2] and *Commissioner* v. *Palm Springs Holding Corp.*, 119 F. 2d 846, decided by the Circuit Court of Appeals for the Ninth Circuit and *Helvering* v. *New President Corp.*, 122 F. 2d 92, decided by the Circuit Court of Appeals for the Eighth Circuit.

The answer to the question[3] turns on the meaning of that part of § 112(i)(1) of the Revenue Act of 1928 (45 Stat. 791, 818) which provides: "The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of . . . substantially all the properties of another corporation. . . ."

[1] Petitioner now takes the position that the new basis should be measured by the market value of the assets rather than the bid price. See Bondholders Committee v. Commissioner, No. 128, decided this day.

[2] And see Commissioner v. Kitselman, 89 F. 2d 458, and Commissioner v. Newberry Lumber & Chem. Co., 94 F. 2d 447, which are in accord with the decision below.

[3] If there was a "reorganization", the respondent was entitled to use the asset basis of the old corporation as provided in § 113(a)(7).

The essential facts can be stated briefly. The old corporation was a subsidiary of a corporation which was in receivership in 1929. Stockholders of the parent had financed the old corporation taking unsecured notes for their advances. Maturity of the notes was approaching and not all of the noteholders would agree to take stock for their claims. Accordingly a creditors' committee was formed late in 1929 and a plan of reorganization was proposed to which all the noteholders, except two, assented. The plan provided that a new corporation would be formed which would acquire all the assets of the old corporation. The stock of the new corporation, preferred and common, would be issued to the creditors in satisfaction of their claims. Pursuant to the plan involuntary bankruptcy proceedings were instituted in 1930. The appraised value of the bankrupt corporation's assets was about $155,000. Its obligations were about $838,000, the unsecured notes with accrued interest aggregating somewhat over $793,000. The bankruptcy trustee offered the assets for sale at public auction. They were bid in by the creditors' committee for $150,000. The price was paid by $15,000 in cash, by agreements of creditors to accept stock of a new corporation in full discharge of their claims, and by an offer of the committee to meet the various costs of administration, etc. Thereafter respondent was formed and acquired all the assets of the bankrupt corporation. It does not appear whether the acquisition was directly from the old corporation on assignment of the bid or from the committee. Pursuant to the plan respondent issued its stock to the creditors of the old corporation—over 95% to the noteholders and the balance to small creditors. Nonassenting creditors were paid in cash. Operations were not interrupted by the reorganization and were carried on subsequently by substantially the same persons as before.

From the *Pinellas* case (287 U. S. 462) to the *Le Tulle* case (308 U. S. 415) it has been recognized that a transaction may not qualify as a "reorganization" under the various revenue acts though the literal language of the statute is satisfied. See Paul, Studies in Federal Taxation (3d Series), pp. 91 *et seq.* The *Pinellas* case introduced the continuity of interest theory to eliminate those transactions which had "no real semblance to a merger or consolidation" (287 U. S. p. 470) and to avoid a construction which "would make evasion of taxation very easy." *Id.* p. 469. In that case the transferor received, in ex-

change for its property cash and short term notes. This Court said (*id.* p. 470) "Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes." In the *Le Tulle* case, we held that the term of the obligation received by the seller was immaterial. "Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise." 308 U. S. pp. 420-421. On the basis of the continuity of interest theory as explained in the *Le Tulle* case it is now earnestly contended that a substantial ownership interest in the transferee company must be retained by the holders of the ownership interest in the transferor. That view has been followed by some courts. *Commissioner* v. *Palm Springs Holding Corp.*, *supra*; *Helvering* v. *New President Corp.*, *supra*. Under that test there was "no reorganization" in this case since the old stockholders were eliminated by the plan, no portion whatever of their proprietary interest being preserved for them in the new corporation. And it is clear that the fact that the creditors were for the most part stockholders of the parent company does not bridge the gap. The equity interest in the parent is one step removed from the equity interest in the subsidiary. In any event, the stockholders of the parent were not granted participation in the plan *qua* stockholders.

We conclude, however, that it is immaterial that the transfer shifted the ownership of the equity in the property from the stockholders to the creditors of the old corporation. Plainly the old continuity of interest was broken. Technically that did not occur in this proceeding until the judicial sale took place. For practical purposes, however, it took place not later than the time when the creditors took steps to enforce their demands against their insolvent debtor. In this case, that was the date of the institution of bankruptcy proceedings. From that time on they had effective command over the disposition of the property. The full priority rule of *Northern Pacific R. Co.* v. *Boyd*, 228 U. S. 482, applies to proceedings in bankruptcy as well as to equity receiverships. *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106. It gives creditors, whether secured or unsecured, the right to exclude stockholders entirely from the reorganization plan when the debtor is

insolvent. See *In re 620 Church St. Bldg. Corp.*, 299 U. S. 24. When the equity owners are excluded and the old creditors become the stockholders of the new corporation, it conforms to realities to date their equity ownership from the time when they invoked the processes of the law to enforce their rights of full priority. At that time they stepped into the shoes of the old stockholders. The sale "did nothing but recognize officially what had before been true in fact." *Helvering* v. *New Haven & S. L. R. Co.*, 121 F. 2d 985, 987.

That conclusion involves no conflict with the principle of the *Le Tulle* case. A bondholder interest in a solvent company plainly is not the equivalent of a proprietary interest, even though upon default the bondholders could retake the property transferred. The mere possibility of a proprietary interest is of course not its equivalent. But the determinative and controlling factors of the debtor's insolvency and an effective command by the creditors over the property were absent in the *Le Tulle* case.

Nor are there any other considerations which prevent this transaction from qualifying as a "reorganization" within the meaning of the Act. The *Pinellas* case makes plain that "merger" and "consolidation" as used in the Act includes transactions which "are beyond the ordinary and commonly accepted meaning of those words". 287 U. S. p. 470. Insolvency reorganizations are within the family of financial readjustments embraced in those terms as used in this particular statute. Some contention, however, is made that this transaction did not meet the statutory standard because the properties acquired by the new corporation belonged at that time to the committee and not to the old corporation. That is true. Yet the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the complete affair. *Gregory* v. *Helvering*, 293 U. S. 465; *Helvering* v. *Bashford*, 302 U. S. 454. Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan.

Affirmed.

Mr. Justice ROBERTS did not participate in the consideration or decision of this case.